



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-100400-14]

RIN 1545-BM14

Guidance Regarding Reporting Income and Deductions of a Corporation That Becomes or Ceases to be a Member of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the consolidated return regulations. These proposed regulations would revise the rules for reporting certain items of income and deduction that are reportable on the day a corporation joins or leaves a consolidated group. The proposed regulations would affect such corporations and the consolidated groups that they join or leave.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-100400-14), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-100400-14), Courier's Desk, Internal Revenue

Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov/> (IRS REG-100400-14).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Russell G. Jones, (202) 317-6847; concerning the submission of comments or to request a public hearing, Oluwafunmilayo (Funmi) P. Taylor, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

1. Introduction

This notice of proposed rulemaking contains proposed regulations that amend 26 CFR part 1 under section 1502 of the Internal Revenue Code (Code). Section 1502 authorizes the Secretary to prescribe regulations for corporations that join in filing a consolidated return, and it expressly provides that those rules may be different from the provisions of chapter 1 of subtitle A of the Code that would apply if those corporations filed separate returns. Terms used in the consolidated return regulations generally are defined in §1.1502-1.

These proposed regulations provide guidance under §1.1502-76, which prescribes rules for determining the taxable period in which items of income, gain, deduction, loss, and credit (tax items) of a corporation that joins in filing a consolidated return are included. Section 1.1502-76(b) provides, in part, that if a corporation (S) becomes or ceases to be a member of a consolidated group during a consolidated return year, S must include in the consolidated return its tax items for the period during

which it is a member. S also must file a separate return (including a consolidated return of another group) that includes its items for the period during which it is not a member.

2. Prior and Current Regulations

On September 8, 1966, the IRS and the Treasury Department promulgated regulations under §1.1502-76 in TD 6894, 31 FR 11794 (1966 regulations). Section 1.1502-76(b) of the 1966 regulations was silent regarding the treatment of S's tax items that accrued on the day S became or ceased to be a member of a consolidated group (S's change in status). Thus, whether S's tax items for the day of S's change in status should have been reflected on S's tax return for the short period ending with S's change in status, or whether these tax items should have been reflected instead on S's tax return for the short period beginning after S's change in status, was unclear under the 1966 regulations.

On August 15, 1994, the IRS and the Treasury Department published final regulations (TD 8560; 59 FR 41666) under §1.1502-76(b) (current regulations) that revised the 1966 regulations to eliminate uncertainty regarding the treatment of tax items recognized by S on the day of S's change in status. Under the general rule of §1.1502-76(b)(1)(ii)(A)(1) of the current regulations (current end of the day rule), S is treated for all federal income tax purposes as becoming or ceasing to be a member of a consolidated group at the end of the day of S's change in status, and S's tax items that are reportable on that day generally are included in the tax return for the taxable year that ends as a result of S's change in status.

The notice of proposed rulemaking that proposed the current end of the day rule (57 FR 53634, Nov. 12, 1992) (1992 NPRM) indicated that the current end of the day

rule was intended to provide certainty and prevent inconsistent reporting of S's items between the consolidated and separate returns. Prior to the 1992 NPRM, some taxpayers had inferred (based upon the administrative practice of the IRS) that the inclusion in a particular return of a tax item of S incurred on the day of S's change in status depended on a factual determination of whether the transaction occurred before or after noon on the day of S's change in status (the so-called "lunch rule").

There are two exceptions to the current end of the day rule. The first exception (in §1.1502-76(b)(1)(ii)(A)(2)) provides that if a corporation is an S corporation (within the meaning of section 1361(a)(1)) immediately before becoming a member of a consolidated group, the corporation becomes a member of the group at the beginning of the day the termination of its S corporation election is effective (termination date), and its taxable year ends for all federal income tax purposes at the end of the preceding day (S corporation exception). The S corporation exception was added by TD 8842 (64 FR 61205; Nov. 10, 1999) to eliminate the need to file a one-day C corporation return for the day an S corporation is acquired by a consolidated group. No additional rule was necessary with respect to a qualified S corporation subsidiary (QSub) of an S corporation that joins a consolidated group. See §1.1361-5(a)(3).

Added at the same time as the current end of the day rule, the second exception (in §1.1502-76(b)(1)(ii)(B)) provides that if a transaction occurs on the day of S's change in status that is properly allocable to the portion of S's day after the event resulting in S's change in status, S and certain related persons must treat the transaction as occurring at the beginning of the following day for all federal income tax purposes (current next day rule). The current next day rule was added in response to comments to the 1992

NPRM suggesting that the current end of the day rule created a “seller beware” problem with respect to S’s tax items arising on the day of S’s change in status but after the event causing S’s change in status. Commenters suggested that, for example, if consolidated group A sold the stock of S to consolidated group B, and group B caused S to sell one of its divisions on the same day it was acquired by group B, the gain from the sale of the division would be inappropriately allocable to group A’s consolidated return. Commenters recommended that final regulations adopt rules substantially similar to the current next day rule to protect the reasonable expectations of sellers and buyers of S’s stock. Commenters suggested that a rule providing this type of protection was most appropriate with respect to extraordinary items, and some commenters suggested that a rule similar to the current next day rule should operate unless the seller and buyer of S agreed otherwise.

3. Proposed Regulations

A. Overview

The IRS and the Treasury Department have determined that changes should be made to the regulations under §1.1502-76(b) due to uncertainty regarding the appropriate application of the current next day rule. These proposed regulations address this concern as well as additional concerns with the current regulations, as summarized in this section 3.A. and discussed in greater detail in sections 3.B. through 3.K. of this preamble.

To provide certainty, the proposed regulations generally clarify the period in which S must report certain tax items by replacing the current next day rule with a new exception to the end of the day rule (proposed next day rule) that is more narrowly

tailored to clearly reflect taxable income and prevent certain post-closing actions from adversely impacting S's tax return for the period ending on the day of S's change in status. The proposed next day rule applies only to "extraordinary items" (as defined in §1.1502-76(b)(2)(ii)(C) of the proposed regulations) that result from transactions that occur on the day of S's change in status, but after the event causing the change, and that would be taken into account by S on that day. This rule requires those extraordinary items to be allocated to S's tax return for the period beginning the next day. The proposed next day rule is expressly inapplicable to any extraordinary item that arises simultaneously with the event that causes S's change in status.

The proposed regulations further clarify that fees for services rendered in connection with S's change in status constitute a "compensation-related deduction" for purposes of §1.1502-76(b)(2)(ii)(C)(9) (if payment of the fees would give rise to a deduction), and therefore an extraordinary item. The proposed regulations also clarify that the anti-avoidance rule in §1.1502-76(b)(3) may apply to situations in which a person modifies an existing contract or other agreement in anticipation of S's change in status.

The proposed regulations also add a rule (previous day rule, described in section 3.C. of this preamble) to clarify the application of the S corporation exception. In addition, the proposed regulations limit the scope of the end of the day rule, the next day rule, the S corporation exception, and the previous day rule to determining the period in which S must report certain tax items and determining the treatment of an asset or a tax item for purposes of sections 382(h) and 1374 (as opposed to applying for all federal income tax purposes).

Additionally, the proposed regulations provide that short taxable years resulting from intercompany transactions to which section 381(a) applies (intercompany section 381 transactions) are not taken into account in determining the carryover period for a tax item of the distributor or transferor member in the intercompany section 381 transaction or for purposes of section 481(a). Furthermore, the proposed regulations provide that the due date for filing S's separate return for the taxable year that ends as a result of S becoming a member is not accelerated if S ceases to exist in the same consolidated return year.

The proposed regulations make several other conforming and non-substantive changes to the current regulations as well. Finally, the proposed regulations add several examples to illustrate the proposed rules.

The IRS and the Treasury Department note that neither the current regulations nor the proposed regulations are intended to supersede general rules in the Code and regulations concerning whether an item is otherwise includible or deductible.

B. Proposed Next Day Rule

The current next day rule provides that S and certain related persons must treat a transaction as occurring at the beginning of the day following S's change in status if the transaction occurs on the day of S's change in status and is "properly allocable" to the portion of that day following S's change in status. The IRS and the Treasury Department believe, however, that the standards provided in the current next day rule for determining whether a transaction is "properly allocable" to the portion of S's day after the event resulting in S's change in status have been inappropriately interpreted by taxpayers. The current next day rule provides that a determination of whether a

transaction is “properly allocable” to the portion of S’s day after the event resulting in S’s change in status is respected if it is “reasonable and consistently applied by all affected persons.” In determining whether an allocation is “reasonable,” certain factors enumerated in the current regulations are to be considered, including whether tax items arising from the same transaction are allocated inconsistently. Some taxpayers have interpreted these rules as providing flexibility in reporting tax items that result from transactions occurring on the day of S’s change in status so that those items can be allocated by agreement to the day of, or to the day following, S’s change in status. The IRS and the Treasury Department view this interpretation of the current next day rule as inappropriate because it effectively would permit taxpayers to elect the income tax return on which these tax items are reported and therefore may not result in an allocation that clearly reflects taxable income. This electivity is inconsistent with the purpose of §1.1502-76(b) to clearly reflect the income of S and the consolidated group. Further, the IRS and the Treasury Department have observed that the current regulations create controversy between taxpayers and the IRS as to whether certain of S’s tax items that become reportable on the day of S’s change in status are properly allocated to S’s tax return for the period ending that day rather than to S’s tax return for the period beginning the next day.

The proposed next day rule is intended to eliminate the perceived electivity and the source of these controversies. Under the proposed regulations, the application of the proposed next day rule is mandatory rather than elective—if an extraordinary item results from a transaction that occurs on the day of S’s change in status, but after the event resulting in the change, and if the item would be taken into account by S on that

day, the transaction resulting in the extraordinary item is treated as occurring at the beginning of the following day for purposes of determining the period in which S must report the item.

The proposed regulations also provide that the proposed next day rule is inapplicable to items that arise simultaneously with the event that causes S's change in status. Under the end of the day rule (as revised by these proposed regulations), those items are reported on S's tax return for the short period ending on the day of S's change in status. The proposed regulations are expected to afford taxpayers and the IRS greater certainty regarding the period to which S's tax items resulting from such a transaction are allocated.

C. Previous Day Rule

As noted in section 2 of this preamble, the special rule for S corporations provides an exception to the end of the day rule if an S corporation joins a consolidated group. To avoid creating a one-day C corporation tax return for the termination date, the S corporation exception provides that S becomes a member of the group at the beginning of the termination date, and that S's taxable year ends for all federal income tax purposes at the end of the preceding day.

Although these proposed regulations retain the S corporation exception, the proposed regulations add a previous day rule that mirrors the principles of the proposed next day rule. Whereas the proposed next day rule requires extraordinary items resulting from transactions that occur on the day of S's change in status (but after the event causing the change) to be allocated to S's tax return for the short period that begins the following day, the previous day rule requires extraordinary items resulting

from transactions that occur on the termination date (but before or simultaneously with the event causing S's status as an S corporation to terminate) to be allocated to S's tax return for the short period that ends on the previous day (that is, the day preceding the termination date).

D. Revised Scope of the End of the Day Rule and Related Rules

Under the current end of the day rule, S becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends "for all federal income tax purposes" at the end of that day. However, applying the end of the day rule for purposes other than the reporting of S's tax items could yield results inconsistent with other consolidated return rules. For example, under §§1.1502-13 and 1.1502-80(d)(1), if a member contributes property subject to a liability in excess of the property's basis to a nonmember in exchange for the nonmember's stock, and if the transferee becomes a member of the transferor's consolidated group as a result of the exchange, the transaction is treated as an intercompany transaction and section 357(c) does not apply. However, if the end of the day rule applies "for all federal income tax purposes," it may be unclear whether the transferee becomes a member "immediately after the transaction," whether the transaction is an intercompany transaction, and whether section 357(c) could apply to the transaction.

To eliminate possible confusion arising from application of the current end of the day rule and related rules, these proposed regulations provide that the end of the day rule, the proposed next day rule, the S corporation exception, and the previous day rule apply for purposes of determining the period in which S must report its tax items, as well as for purposes of sections 382(h) and 1374 (discussed in section 3.I. of this preamble).

E. Extraordinary Items

The proposed next day rule mandatorily applies to extraordinary items that result from a transaction that occurs on the day of S's change in status but after the event that causes the change. In contrast, the previous day rule mandatorily applies to extraordinary items that result from a transaction that occurs on the day of S's change in status but before or simultaneously with the event that causes S's status as an S corporation to terminate.

One category of extraordinary items, set forth in §1.1502-76(b)(2)(ii)(C)(9) of the current regulations, applies to any "compensation-related deduction in connection with S's change in status." The proposed regulations clarify that this category of extraordinary items includes (among other items) a deduction for fees for services rendered in connection with S's change in status. For example, if payment of a fee for the services of a financial adviser is contingent upon a successful acquisition of S's stock, to the extent the fee gives rise to a deduction, the deduction for the accrual of that expense is an extraordinary item, and the deduction is allowable only in S's taxable year that ends at the close of the day of the change.

The IRS and the Treasury Department request comments as to whether the list of extraordinary items set forth in §1.1502-76(b)(2)(ii)(C) should be modified to include any item not currently listed or whether any item currently included should be deleted or modified. Specifically, the IRS and the Treasury Department are considering whether the item in §1.1502-76(b)(2)(ii)(C)(5) ("[a]ny item carried to or from any portion of the original year (e.g., a net operating loss carried under section 172), and any section 481(a) adjustment") should be modified to include "any section 481(a) adjustment or the

acceleration thereof,” and whether the item in §1.1502-76(b)(2)(ii)(C)(6) (“[t]he effects of any change in accounting method initiated by the filing of the appropriate form after S's change in status”) should continue to be included in the list of extraordinary items.

The IRS and the Treasury Department also request comments as to whether any extraordinary item should be excluded, in whole or in part, from application of the next day rule and the previous day rule. In particular, the IRS and the Treasury Department request comments as to whether the extraordinary items set forth in §1.1502-76(b)(2)(ii)(C)(5) and (6) of the current regulations should be excluded, in whole or in part, from application of these rules.

F. Ratable Allocation

Rather than require S to perform a closing of the books on the day of its change in status, the current regulations under §1.1502-76(b)(2)(ii) permit S's tax items, other than the extraordinary items, to be ratably allocated between S's two short taxable years if certain conditions are met. The IRS and the Treasury Department request comments as to whether S no longer should be permitted to elect to ratably allocate its tax items between the periods ending and beginning with S's change in status.

G. Certain Foreign Entities

Solely for purposes of determining the short taxable year of S to which the items of a passthrough entity in which S owns an interest are allocated, §1.1502-76(b)(2)(vi)(A) of the current regulations generally provides that S is treated as selling or exchanging its entire interest in the entity immediately before S's change in status. This rule does not apply to certain foreign corporations the ownership of which may give rise to deemed income inclusions under the Code. In addition, a deemed income inclusion

from a foreign corporation and a deferred tax amount from a passive foreign investment company under section 1291 are treated as extraordinary items under §1.1502-76(b)(2)(ii)(C)(11). The IRS and the Treasury Department request comments as to whether such deemed income inclusions or deferred tax amounts should continue to be treated as extraordinary items, whether rules having similar effects to the rule in §1.1502-76(b)(2)(vi)(A) relating to passthrough entities should be adopted for controlled foreign corporations and passive foreign investment companies in which S owns an interest, and whether any other changes should be made to §1.1502-76(b)(2)(vi) of the current regulations.

H. Anti-Avoidance Rule

Under §1.1502-76(b)(3) of the current regulations, if any person acts with a principal purpose contrary to the purposes of §1.1502-76(b) to substantially reduce the federal income tax liability of any person (prohibited purpose), adjustments must be made as necessary to carry out the purposes of §1.1502-76 of the current regulations (anti-avoidance rule). The proposed regulations clarify that the anti-avoidance rule may apply to situations in which a person modifies an existing contract or other agreement in anticipation of S's change in status in order to shift an item between the taxable years that end and begin as a result of S's change in status if such actions are undertaken with a prohibited purpose. The IRS and the Treasury Department request comments regarding this proposed amendment to the anti-avoidance rule.

I. Coordination with Sections 382(h) and 1374

1. Section 382

For purposes of section 382, the term recognized built-in loss (RBIL) means any loss recognized during the recognition period on the disposition of any asset held by the loss corporation immediately before the date of the section 382 ownership change (change date), to the extent the loss reflects a built-in loss on the change date. Section 382(h)(2)(B). The term recognition period means the five-year period beginning on the change date. Section 382(h)(7)(A).

Section 382(h)(1)(B) generally provides that if a loss corporation has a net unrealized built-in loss (NUBIL), then any RBIL taken into account in a taxable year any portion of which falls in the recognition period (recognition period taxable year) is treated as a deduction subject to the loss corporation's section 382 limitation as if the RBIL were a pre-change loss. The amount of RBILs subject to the section 382 limitation in any recognition period taxable year is limited, however, to the excess of the NUBIL over total RBILs in prior taxable years ending in the recognition period. (The amount of such excess is referred to in this preamble as the outstanding NUBIL balance.) In other words, the amount of the NUBIL limits the amount of RBILs that are treated as pre-change losses, and any built-in loss treated as an RBIL further reduces the outstanding NUBIL balance.

In many cases, the event that causes S's change in status for purposes of §1.1502-76(b)(1)(ii) also causes S to undergo an ownership change for purposes of section 382. Thus, an item of deduction or loss that becomes reportable on the day of S's change in status falls within the recognition period beginning that day, even if the item is allocated to S's short period ending that day under the end of the day rule. As a consequence, an item that should be a pre-change loss is treated as an RBIL that

reduces the outstanding NUBIL balance. For example, assume consolidated group A sells all of S's stock to consolidated group B. If on the day of S's change in status (but before the event causing the change), S recognizes a loss on the sale of an asset, under the end of the day rule the loss is reported on group A's consolidated return. However, notwithstanding that the loss may not be claimed by group B, the loss may be treated as an RBIL and reduce the outstanding NUBIL balance.

To prevent such an outcome, these proposed regulations provide that, for purposes of section 382(h), items includible in the short taxable year that ends as a result of S's change in status (including items allocated to that taxable year under the end of the day rule) are not treated as occurring in the recognition period. Rather, only items includible in S's short taxable year that begins as a result of S's change in status (including items allocated to that taxable year under the proposed next day rule) are treated as occurring in the recognition period. Therefore, the beginning of the recognition period for purposes of section 382(h) would correspond with the beginning of S's short taxable year that begins on the day after S's change in status.

2. Section 1374

Section 1374 generally imposes a corporate-level tax (section 1374 tax) on the recognition of gain by an S corporation that formerly was a C corporation (or that acquired assets from a C corporation in a transferred basis transaction) during a recognition period specified in section 1374(d)(7) (section 1374 recognition period), but only to the extent of the corporation's net recognized built-in gain (as defined in section 1374(d)(2)) for a given taxable year. The section 1374 tax also applies to certain tax items attributable to the corporation's C corporation taxable years. In addition,

regulations under section 337(d) extend section 1374 treatment to (1) a C corporation's conversion to a real estate investment trust (REIT), regulated investment company (RIC), and certain tax-exempt entities, or (2) certain cases in which a REIT, RIC, or tax-exempt entity acquires assets in a transferred basis transaction from a C corporation.

As with the application of section 382(h), the event that causes S's change in status for purposes of §1.1502-76(b)(1)(ii) may be the event that results in S being a corporation that is subject to the section 1374 tax. Therefore, it is necessary to determine in which return (the group's consolidated return or S's separate return beginning the day after S's change in status) S's tax items for the day of S's change in status are included. Similarly, if the event that causes S's change in status for purposes of §1.1502-76(b)(1)(ii) is the event that results in S ceasing to be a corporation subject to the section 1374 tax, it is necessary to determine in which return (the group's consolidated return or S's separate return for the period ending the day before S's change in status) S's tax items for the day of S's change in status are included. The proposed regulations thus provide that if S ceases to be a corporation subject to the section 1374 tax upon becoming a member, or if S elects to be a corporation that is subject to the section 1374 tax for its first separate return year after ceasing to be a member, S's items of recognized built-in gain or loss for purposes of section 1374 will include only the amounts reported on S's separate return (including items reported on that return under the previous day rule or the next day rule).

J. Intercompany Section 381 Transactions

Under the current consolidated return regulations, if a member distributes or transfers its assets to another corporation that is a member immediately after the

distribution or transfer in an intercompany section 381 transaction, and if the distributor or transferor member has a net operating loss carryover or a net capital loss carryover, the distributor or transferor member will not be treated as having a short taxable year for purposes of determining the years to which the loss may be carried. Sections 1.1502-21(b)(3)(iii) and 1.1502-22(b)(4).

These proposed regulations would amend current law by moving these rules to §1.1502-76(b)(2)(i) and making conforming changes to §§1.1502-21(b)(3)(iii) and 1.1502-22(b)(4). In addition, these proposed regulations would expand these rules by providing that a short taxable year of the distributor or transferor member by reason of an intercompany section 381 transaction is not counted as a separate taxable year for purposes of determining either the taxable years to which any tax attribute of the distributor or transferor member may be carried or the taxable years in which an adjustment under section 481(a) is taken into account. No inference should be drawn from the proposed changes to these rules as to whether a short taxable year of a member resulting from an intercompany section 381 transaction is counted under current law for purposes of determining the years to which a tax credit may be carried or in which a section 481 adjustment is taken into account.

K. Due Date for Filing Tax Returns

The proposed regulations also eliminate a provision that could cause taxpayers to inadvertently miss a return filing deadline. Under §1.1502-76(b)(4) of the current regulations, if S joins a consolidated group, the due date for filing S's separate return is the earlier of the due date (with extensions) of the group's return or the due date (with extensions) of S's return if S had not joined the group. If S goes out of existence during

the consolidated return year in which S joins a group, its taxable year would end. Under section 6072, the due date for S's short period return would be the 15th day of the third month (ninth month, with extensions) following the date on which S ceases to exist. Accordingly, if S ceases to exist during the same consolidated return year in which it becomes a member, the due date for S's tax return for the short period that ended as a result of S becoming a member could be accelerated. To prevent a taxpayer from inadvertently missing a filing date and being subject to potential penalties for filing a late return, the proposed regulations provide that if S goes out of existence in the same consolidated return year in which it becomes a member, the due date for filing S's separate return is determined without regard to S's ceasing to exist.

L. Non-Substantive Changes

In addition to the changes described in this preamble, the proposed regulations make several non-substantive changes to the current regulations, including moving an example concerning §1.1502-80(d) from the text of §1.1502-76(b)(1)(ii)(B)(2) of the current regulations to §1.1502-13(c)(7)(ii), Example 3(e).

Effective/Applicability Date

The amendments to §§1.1502-21(b)(3)(iii), 1.1502-22(b)(4)(i), 1.1502-76(b)(2)(i), and 1.1502-76(b)(4) will apply to consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**. The other amendments to §1.1502-76(b) will apply to corporations becoming or ceasing to be members of consolidated groups on or after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant impact on a substantial number of small entities. This certification is based on the fact that the regulations apply only to transactions involving corporations that file consolidated federal income tax returns, and that such corporations tend to be larger businesses. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The IRS and the Treasury Department request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Russell G. Jones of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1361-5 also issued under 26 U.S.C. 1361. * * *

Section 1.1362-3 also issued under 26 U.S.C. 1362. * * *

Section 1.1502-13 also issued under 26 U.S.C. 1502. * * *

Section 1.1502-21 also issued under 26 U.S.C. 1502. * * *

Section 1.1502-22 also issued under 26 U.S.C. 1502. * * *

Section 1.1502-28 also issued under 26 U.S.C. 1502. * * *

Section 1.1502-76 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502. * * *

§ 1.1361-5 [Amended]

Par. 2. Section 1.1361-5 is amended:

1. In paragraph (a)(3), by removing “§1.1502-76(b)(1)(ii)(A)(2) (relating to a special rule” and adding “§1.1502-76(b)(1)(ii)(B) (relating to special rules” in its place.

2. In paragraph (a)(4), Example 4, by removing “§1.1502-76(b)(1)(ii)(A)(2)” and adding “§1.1502-76(b)(1)(ii)(B)(1)” in its place.

§ 1.1362-3 [Amended]

Par. 3. Section 1.1362-3 is amended in paragraph (a) by removing “§ 1.1502-76(b)(1)(ii)(A)(2)” and adding “§1.1502-76(b)(1)(ii)(B)” in its place.

Par. 4. Section 1.1502-13 is amended by adding Example 3(e) to paragraph (c)(7)(ii) to read as follows:

§1.1502-13 Intercompany transactions.

* * * * *

(c) * * *

(7) * * *

(ii) * * *

Example 3. * * *

(e) Liability in excess of basis. The facts are the same as in paragraph (a) of this Example 3, except that S and B are not members of the same consolidated group immediately before S’s transfer of the land to B, and the land is encumbered with an \$80 liability. Immediately after the transfer, S and B are members of the same consolidated group. Thus, the transfer is an intercompany transaction to which section 357(c) does not apply pursuant to §1.1502-80(d).

* * * * *

Par. 5. Section 1.1502-21 is amended by revising paragraph (b)(3)(iii) and adding paragraph (h)(1)(iv) to read as follows:

§1.1502-21 Net operating losses.

* * * * *

(b) * * *

(3) * * *

(iii) Short years in connection with intercompany transactions to which section 381(a) applies. If a member distributes or transfers assets in an intercompany transaction to which section 381(a) applies, see §1.1502-76(b)(2)(i).

* * * * *

(h) * * *

(1) * * *

(iv) Paragraph (b)(3)(iii) of this section applies to consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**. For transactions occurring before the date these regulations are published as final regulations in the **Federal Register**, see §1.1502-21(b) as contained in 26 CFR part 1, revised as of April 1 preceding the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 6. Section 1.1502-22 is amended by:

1. Revising paragraph (b)(4)(i).
2. Revising the heading of paragraph (h).
3. Adding paragraph (h)(1)(iii).

The revisions and addition read as follows:

§1.1502-22 Consolidated capital gain and loss.

* * * * *

(b) * * *

(4) Special rules--(i) Short years in connection with intercompany transactions to which section 381(a) applies. If a member distributes or transfers assets in an intercompany transaction to which section 381(a) applies, see §1.1502-76(b)(2)(i).

* * * * *

(h) Effective/applicability date--

(1) * * *

(iii) Paragraph (b)(4)(i) of this section applies to consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**. For transactions occurring before the date these regulations are published as final regulations in the **Federal Register**, see §1.1502-22(b) as contained in 26 CFR part 1, revised as of April 1 preceding the date these regulations are published as final regulations in the **Federal Register**.

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§ 1.1502-28 [Amended]

Par. 7. Section 1.1502-28 is amended in paragraph (b)(11) by removing “§1.1502-76(b)(1)(ii)(B)” and adding “§1.1502-76(b)(1)(ii)(A)(2)” in its place.

Par. 8. Section 1.1502-76 is amended:

1. By adding a sentence at the end of paragraph (b)(1)(i).
2. By revising paragraphs (b)(1)(ii)(A) and (B).
3. By adding paragraph (b)(1)(ii)(D).
4. By adding a sentence at the end of paragraph (b)(2)(i).
5. By revising paragraph (b)(2)(ii)(C)(9).
6. By removing the last sentence of paragraph (b)(2)(iii).

7. By removing the last sentence of paragraph (b)(2)(v).
8. In paragraph (b)(2)(vi)(C) by removing “paragraph (b)(2)(v)” and adding “paragraph (b)(2)(vi)” in its place.
9. By revising paragraph (b)(3).
10. By adding a sentence at the end of paragraph (b)(4).
11. By adding Examples 8, 9, and 10 to paragraph (b)(5).
12. By revising paragraph (b)(6).

The revisions and additions read as follows:

§1.1502-76 Taxable year of members of group.

* * * * *

(b) * * *

(1) * * *

(i) * * * If a corporation (S) becomes or ceases to be a member in a stock disposition or purchase for which an election under section 336(e) or section 338 is made, paragraphs (b)(1)(ii), (b)(2)(ii), and (b)(2)(iii) of this section do not apply to the transaction.

(ii) * * *

(A) In general--(1) End of the day rule. If S becomes or ceases to be a member during a consolidated return year, S's tax year ends, and (except as provided in paragraph (b)(1)(ii)(A)(2) or paragraph (b)(1)(ii)(B) of this section) for purposes of determining the period in which S must report an item of income, gain, deduction, loss, or credit, S is treated as becoming or ceasing to be a member at the end of the day on which its status as a member changes (end of the day rule).

(2) Next day rule. If an extraordinary item (as defined in paragraph (b)(2)(ii)(C) of this section) results from a transaction that occurs on the day of S's change in status as a member, but after the event resulting in the change, and the item would be taken into account by S on that day, the transaction resulting in the extraordinary item is treated as occurring at the beginning of the following day for purposes of determining the period in which S must report the item (next day rule). The next day rule does not apply to any extraordinary item that becomes includible or deductible simultaneously with the event that causes the change in S's status.

(B) Special rules for former S corporations--(1) Beginning of the day rule. If an election under section 1362(a) is in effect for S immediately before S becomes a member, S is treated as becoming a member at the beginning of the day the termination of its election under section 1362(a) is effective (termination date), and S's taxable year ends at the end of the day preceding the termination date. See §1.1361-5(a)(3) for the treatment of certain qualified S corporation subsidiaries.

(2) Previous day rule. If an extraordinary item (as defined in paragraph (b)(2)(ii)(C) of this section) results from a transaction that occurs on the termination date, but before or simultaneously with the event resulting in the termination of S's election under section 1362(a), and the item would be taken into account by S on that day, the transaction resulting in the extraordinary item is treated as occurring at the end of the previous day for purposes of determining the period in which S must report the item (previous day rule). See §1.1361-5(a)(3) for the treatment of certain qualified S corporation subsidiaries.

* * * * *

(D) Coordination with sections 382 and 1374. If the day of S's change in status is also the date of an ownership change for purposes of section 382, the rules and principles of this section apply in determining the treatment of any item or asset for purposes of section 382(h). Accordingly, if the day of S's change in status is also a change date, the determination of net unrealized built-in gain or loss will reflect the application of both the end of the day rule and the next day rule, to the extent each applies. Moreover, items includible in the taxable year that ends as a result of S's change in status are not treated as occurring in the recognition period described in section 382(h)(7)(A), and items includible in the taxable year that begins as a result of S's change in status are treated as occurring in the recognition period. If S ceases to be a corporation subject to the tax imposed by section 1374 upon becoming a member of a consolidated group, or if S elects to be a corporation that is subject to such tax for its first separate return year after ceasing to be a member, S's items of recognized built-in gain or loss for purposes of section 1374 will include only the amounts reported on S's separate return (including items reported on that return under the previous day rule or the next day rule).

* * * * *

(2) * * *

(i) * * * If a member distributes or transfers assets in an intercompany transaction to which section 381(a) applies, a short taxable year of the distributor or transferor corporation is not taken into account either for purposes of determining the taxable years to which any tax attribute of the distributor or transferor corporation may be

carried or for purposes of determining the taxable years in which an adjustment under section 481(a) is taken into account.

(ii) * * *

(C) * * *

(9) Any compensation-related deduction in connection with S's change in status (including, for example, a deduction for fees for services rendered in connection with S's change in status and for bonus, severance, and option cancellation payments made in connection with S's change in status);

* * * * *

(3) Anti-avoidance rule. If any person acts with a principal purpose contrary to the purposes of this paragraph (b) to substantially reduce the federal income tax liability of any person (including by modifying an existing contract or other agreement in anticipation of a change in S's status to shift an item between the taxable years that end and begin as a result of S's change in status), adjustments must be made as necessary to carry out the purposes of this section.

(4) * * * In addition, if S ceases to exist in the same consolidated return year in which S becomes a member, the due date for filing S's separate return shall be determined without regard to S's ceasing to exist in that year.

(5) * * *

Example 8. Allocation of certain amounts that become deductible on the day of S's change in status--(a) Facts. P purchases all of the stock of S, an accrual-basis, stand-alone C corporation, on June 30 pursuant to a stock purchase agreement. At the time of the stock purchase, S has outstanding nonqualified stock options issued to certain employees. The options did not have a readily ascertainable fair market value when granted, and the options do not provide for a deferral of compensation (as defined in §1.409A-1(b)). Under the option agreements, S is obligated to pay its employees certain amounts in cancellation of their stock options upon a change in control of S. P's

purchase of S's stock causes a change in control of S, and S's obligation to make option cancellation payments to its employees becomes fixed and determinable upon the closing of the stock purchase. Several days after the closing of the stock purchase, S pays its employees the amounts required under the option agreements.

(b) Analysis. P's purchase of S's stock causes S to become a member of the P group at the end of the day on June 30. Under paragraph (b)(2)(ii)(C)(9) of this section, a deduction arising from S's liability to pay its employees in cancellation of their stock options in connection with S's change in status is an extraordinary item that cannot be prorated and must be allocated to June 30. The next day rule is inapplicable to this deduction because S's liability to pay its employees becomes deductible on the day of S's change in status simultaneously with the event that causes S's change in status. Consequently, a deduction for the option cancellation payments must be reported under the end of the day rule on S's tax return for the period ending June 30.

(c) Success-based fees. The facts are the same as in paragraph (a) of this Example 8, except that S also engages a consulting firm to provide services in connection with P's purchase of S's stock. Under the terms of the engagement letter, S's obligation to pay for these services is contingent upon the successful closing of the stock purchase. The stock purchase closes successfully, and S's obligation to pay its consultants becomes fixed and determinable at closing. To the extent S's payment of a success-based fee to its consultants is otherwise deductible, this item is an extraordinary item that cannot be prorated and must be reported under the end of the day rule on S's return for the period ending June 30. (See paragraph (b)(2)(ii)(C)(9) of this section.) The next day rule is inapplicable to the deduction because S's liability to pay its consultants becomes deductible on the day of S's change in status simultaneously with the event that causes S's change in status.

(d) Unwanted assets. The facts are the same as in paragraph (a) of this Example 8, except that, after closing on June 30, S sells to an unrelated party certain assets used in S's trade or business that are not wanted by the P group. Gain or loss on the sale of these assets is an extraordinary item that results from a transaction that occurs on the day of S's change in status, but after the event resulting in the change. Consequently, under the next day rule, the gain or loss must be reported on S's tax return for the period beginning July 1.

Example 9. Redemption that causes a change in status--(a) Facts. P owns 80 shares of S's only class of outstanding stock, and a person whose ownership of S stock is not attributed to P under section 302(c) owns the remaining 20 shares. On June 30, S distributes land with a basis of \$100 and a fair market value of \$140 to P in redemption of all of P's stock in S.

(b) Analysis. As a result of the redemption, S ceases to be a member of P's consolidated group on June 30. S will recognize \$40 of gain under section 311(b) on the distribution of the land to P. The next day rule is inapplicable because S's gain becomes includible on the day of S's change in status simultaneously with the event

that causes S's change in status. Consequently, S's gain must be reported under the end of the day rule in its taxable year ending June 30, during which S was a member of the P group. Under §1.1502-32(b)(2)(i), P's basis in its S stock is increased to reflect S's \$40 gain immediately before the redemption of S's stock.

(c) Partial redemption. The facts are the same as in paragraph (a) of this Example 9, except that S distributes the land to P in redemption of 20 shares of P's stock in S. Thus, immediately after the redemption, P owns 75% (60 shares / 80 shares) of S's outstanding stock, and S's minority shareholder owns 25% (20 shares / 80 shares). The redemption does not satisfy the requirements of section 302(b) and is treated under section 302(d) as a distribution to which section 301 applies. The end of the day rule does not apply for purposes of determining whether P and S are members of the same consolidated group immediately after the redemption. Because P owns only 75% of S's stock immediately after the redemption, the distribution is not an intercompany distribution described in §1.1502-13(f)(2)(i). Thus, P may not exclude any amount of the distribution that is a dividend, and P's basis in S's stock is not reduced under §1.1502-32(b)(2)(iv). P may be entitled to a dividends received deduction under section 243(c) (but see section 1059(e)). For the reasons discussed in paragraph (b) of this Example 9, S's gain under section 311(b) must be reported under the end of the day rule in S's taxable year ending June 30, during which S was a member of the P group.

(d) Distribution of loss property. The facts are the same as in paragraph (a) of this Example 9, except that the land distributed by S to P has a fair market value of \$60 rather than \$140. The end of the day rule applies for purposes of determining the taxable year in which S must take into account its realized loss on the distribution of the land. Thus, under the end of the day rule, S's loss on the distribution of the land, which occurs simultaneously with S's ceasing to be a member, is taken into account in S's taxable year that ends as a result of the redemption. However, the end of the day rule does not apply for other purposes; for example, the rule does not apply in determining whether the transaction is an intercompany distribution or in determining the attributes (as defined in §1.1502-13(b)(6)) of the loss. Therefore, because S is not a member immediately after the distribution, S's loss on the distribution is not recognized under section 311(a). Under the end of the day rule, the loss is taken into account as a noncapital, nondeductible expense on the P group's consolidated return, and under §1.1502-32(b)(1)(i), P's basis in its S stock is decreased by \$40 immediately before S leaves the group.

Example 10. Extraordinary item of S corporation--(a) Facts. On July 1, P purchases all the stock of S, an accrual-basis corporation with an election in effect under section 1362(a). Prior to the sale, S had engaged a consulting firm to find a buyer for S's stock, and the consulting firm's fee was contingent upon the successful closing of the sale of S's stock.

(b) Analysis. To the extent S's payment of the success-based fee to its consultants is otherwise deductible, this item is an extraordinary item (see paragraph

(b)(2)(ii)(C)(9) of this section) that becomes deductible on July 1 simultaneously with the event that terminates S's election as an S corporation. Under paragraph (b)(1)(ii)(B)(2) of this section, S's obligation to pay the fee is treated as becoming deductible on June 30 under the previous day rule.

(6) Effective/applicability date. Paragraphs (b)(2)(i) and (b)(4) of this section apply to consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**. Otherwise, this paragraph (b)

applies to corporations becoming or ceasing to be members of consolidated groups on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

John Dalrymple

Deputy Commissioner for Services and Enforcement.